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Currency convertibility and monetary cooperation within integration groupings of developing countries

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ABBREVIATIONS

ABC	Clearing Bank Association
ACU	Asian Clearing Union
AMU	Asian Monetary Unit
CACH	Central American Clearing House
CAfCH	Central African Clearing House
CARICOM	Caribbean Community
CAUA	Central African Unit of Account
CFA	Communauté/Coopération financière africaine
CHCAS	Clearing House of the Economic Community of Central African States
CMCF	CARICOM Multilateral Clearing Facility
CMEA	Council for Mutual Economic Assistance
CPS	Central American Payments System
ECLAC	Economic Commission for Latin America and the Caribbean
ECOWAS	Economic Community of West African States
ECU	European Currency Unit
EPU	European Payments Union
ERM	Exchange Rate Mechanism
EU	European Union
f.o.b.	free on board
GCC	Cooperation Council of the Arab States of the Gulf
IMF	International Monetary Fund
LAFTA	Latin American Free Trade Association
LAIA	Latin American Integration Association
LERMS	Liberalized Exchange Rate Management System
LIMEAN	London interbank mean rate
MERCOSUR	Southern Cone Common Market
OECD	Organisation for Economic Cooperation and Development
OEEC	Organisation for European Economic Cooperation
PTA	Preferential Trade Area for Eastern and Southern African States
SDR	special drawing rights
UAPTA	Unit of Account of the PTA
WACH	West African Clearing House
WAMU	West African Monetary Union
WAUA	West African Unit of Account

Chapter I
Introduction and summary

1. In a globalized world economy, the convertibility of national currencies and international units of account has become a major requirement. Efforts towards the expansion of trade and other international transactions by countries and regions can be significantly aided if local currencies are convertible. Thus, both from the standpoint of international economic cooperation and policy makers, if all the domestic and external conditions of sustainability are in place, convertibility is a desirable objective.

2. There are two developments in the world economy which make currency convertibility particularly interesting and desirable. Firstly, the ongoing liberalization of the national economies of many developing countries, which encompasses elements such as financial and capital account liberalization, has a direct link to currency convertibility. Liberalization is a process which brings about both benefits and risks.[1] Secondly, in certain Central and Eastern European States, as well as in some socialist countries in Asia, the issue of convertibility has started to gain both practical and symbolic meanings since the late 1960s when these countries embarked on market-oriented reforms and rediscovered the importance of financial links with the outside world. The recent political and economic changes in Central Europe and the deepening of the market reforms in Asian socialist countries further increase the importance attached to convertibility in these regions.

3. Convertibility is not an end in itself but rather a means to participate in the world economy. In some sense, it is also an indicator of the state of health of the external balance and, to an extent, the internal economy.

4. The historical as well as the current examples of achieving convertibility, especially in developing countries, seem to pass through a stage of "regional" (limited) convertibility. This is an arrangement which promotes the convertibility of currencies among countries that are geographically and historically close and that engage in a large volume of intratrade. This is to be contrasted with "global" convertibility, a category not limited to specific countries or to specific accounts among these countries.

5. In view of the desirability of global convertibility, the question arises as to whether regional (limited) convertibility is compatible. In the following analysis, it is argued that regional convertibility is compatible, and is, at least, a useful and realistic transitional measure towards achieving global convertibility.

6. Convertibility is a means to support both regional cooperation and global integration, goals that are complementary rather than exclusive.

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[1] Since the 1980s, the UNCTAD secretariat has prepared several reports on the impact of financial openness on developing countries. For a summary, see Part II of the *Trade and Development Report 1990* (UNCTAD/TDR/10), particularly pp.113-114, 120-121.

Although some countries under strong payments pressures may underestimate the importance of regional cooperation and concentrate instead on the improvement of links with their traditional markets in the North, regional convertibility arrangements that are in place may help them to overcome their foreign-exchange problems and contribute to the expansion of South-South trade.

7. This report analyses these issues of currency convertibility and monetary cooperation within integration groupings of developing countries. In chapter II, the definition of convertibility, both as a provision among central banks and as a regional arrangement, is discussed.

8. Chapter III offers a critical look at the preconditions for successful currency convertibility and the criteria most often cited by specialists to measure its success. Chapter IV discusses the extension of currency convertibility from current- to capital-account transactions, analyses the micro- and macroeconomic consequences of convertibility, and deals with the relationship between currency convertibility and regional payments and clearing arrangements.

9. Chapter V analyses some historical examples and draws a few lessons for the future, while chapter VI deals with recent cases of regional convertibility and clearing and payments arrangements and the linkage between them. These two chapters conclude that the key to a successful payments arrangement is a method that facilitates the expansion of regional trade, but that does not lead to the accumulation of arrears. The method may require all the member countries to settle their balances in hard currencies only, or fix ceilings on the automatic credits and gradually reduce credit lines. Another method is the introduction of a currency swap scheme which can be effective in reducing arrears.

10. Chapter VII, based on two recent examples of countries (Argentina and India) that have national plans for global convertibility and that participate in regional payments arrangements, argues that regional arrangements among countries of similar levels of development, if successful, could lead to policies and performance conducive to global convertibility.

Chapter II
The concept of convertibility

11. Although the term "convertibility" is current in economic literature, its definition varies from one study to another. Here, we try to provide some basic notions which can be helpful in clarifying the definition and in distinguishing one country's experience from another's.

12. Convertibility is not an end in itself but a means to attain certain goals: for example, to create an external discipline on economic policies or to transmit international price signals to local producers and consumers. It also creates obligations and may limit, under certain circumstances, the autonomy of monetary policy. Credibility in the context of sound macroeconomic policies is a necessary element of sustainable convertibility. The establishment of domestic and external balances and the general health of the national economy are crucial factors for sustaining convertibility.

13. From a practical point of view, convertibility implies an ability to meet international financial obligations without recourse to controls. In this sense, convertibility covers certain implicit concepts such as a relative balance between receipts and debits over a period of time, and confidence of financial markets in the currency, and hence its acceptability in international markets.

14. Analytically, the concept has multiple aspects. One extreme is a situation of unfettered exchange of currency at a reasonable and steady price, irrespective of who holds the currency. This is called total convertibility. The other extreme is a situation in which there are so many restrictions that any exchange is effected only in the black market at widely fluctuating rates, where there is the possibility of extreme losses or gains to the holders. This is called inconvertibility.

15. In the real world, there is a variety of "in-between" cases. Their common characteristic is the relativity of the concept. More specifically, five different types of convertibility can be distinguished.

a. First, a "de iure" (declared) convertibility means that a country's national authorities formally accept their obligation to convert their national currency into other currencies when a legitimate claim arises. In contrast, "de facto" (or business) convertibility implies that economic actors at home and abroad are willing to accept the national currency in their transactions, with the reasonable expectation that they can change it to other currencies whenever needed. Sometimes, de iure convertibility is not accompanied with de facto acceptance, and sometimes de facto convertibility already exists before the monetary authorities formally accept the obligation of conversion.

b. Second, "global" convertibility may refer to a conversion to all hard currencies, while "regional" (limited) convertibility applies when the currency in question is accepted only within a determined region. Limited

convertibility represents a set of coordinated national exchange arrangements that leads to faster liberalization within regions than with the outside world.[2] Limited currency convertibility could also be envisaged with major trading partners regardless of regional proximity. Within the strict sense of the Articles of Agreement of the International Monetary Fund (IMF), this is not acceptable because convertibility should be global. Interestingly, the IMF concept is not watertight. For example, some countries may participate in limited convertibility arrangements while having their own national currencies declared globally convertible, according to the IMF rules. This seeming paradox may be explained by the fact that the IMF requires convertibility only between central banks, even if other trading parties may have difficulties in freely converting and securing their earnings. In countries where there are controls on exchange rates, such parties might not want to surrender their foreign-exchange balances to their central banks, and thus never invoke this type of convertibility. Another aspect of regional convertibility arrangements is that they are often accompanied by the establishment of a clearing-house. Through the clearing-house, the central bank of a participating country can defer the clearing of its balance to the settlement period and thereby minimize the use of hard currencies. Within the clearing-house, therefore, there is "potential" convertibility invoked in terms of eventual balances.

c. Third, "internal" convertibility means that a national or resident of a country has the right to exchange his national currency to foreign currencies; "external" convertibility refers to the right of a foreigner or non-resident to do the same. (Whether the criteria is national/foreigner or resident/non-resident depends on each country's regulations and methods of classification.) In most cases, external convertibility precedes internal convertibility. Internal convertibility has some restrictions for a longer period of time than the external rights.

d. Fourth, there is the question of whether only current-account transactions should be subject to convertibility, or capital accounts also. This question, discussed in chapter V, is also linked to the general issue of the timing and sequencing of economic reforms, and to the impacts of currency convertibility and exchange rates.

e. Fifth, in most cases, convertibility refers to the quality of a national currency. However, in our contemporary world there is an increased use of other means of exchange; quasi-money, such as the European Currency Unit (ECU), "international" quasi-money, such as special drawing rights (SDR), etc. The quality of convertibility should be extended to such international quasi-moneys.

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[2] For the original formulation of this concept, see Cicin-Sain and J. Marshall, "Study on limited currency convertibility among ECOWAS countries" (UNCTAD/ECDC/142), March 1983.

Chapter III
Conditions ad prerequisites for currency convertibility

16. As convertibility is not an end in itself but a means to attain certain goals, the criteria to assess its success should be pragmatic. One criterion may be the contribution of convertibility to economic growth. Another may be the stimulation of international trade. A third may be the impact of convertibility on the efficiency of resource allocation.

17. Currency convertibility should help to reduce distortions normally associated with foreign-exchange restrictions, thereby improving resource use and allocation efficiency. Gains in productivity and higher output levels could also be realized through increased competition, foreign investment and improved access to foreign inputs, capital goods and technology.

18. It is generally agreed that the convertibility of a currency is effective if certain conditions are met. Some IMF experts, for example, require four prerequisites for the success of programmes of convertibility:[1]

a. equilibrium exchange rates;
b. proper micro- and macro-policies (sound macroeconomic management), effective market environment;
c. fixed exchange rate; and
d. adequate level of reserves.

19. We argue here that the first two conditions are indeed necessary for currency convertibility, but that the last two are not.

20. Regarding equilibrium exchange rates, it may be argued that as full convertibility is a means to meet international obligations without resorting to exchange controls, an equilibrium exchange rate that is consistent with a long-term balance in external payments is indispensable for maintaining convertibility without permanently straining foreign reserves. The mere fact that the conversion of a national currency into foreign currencies is taking place somewhere is not enough because a non-convertible currency is always accepted on the condition that its holder accept any unfavourable exchange rate offered. If any exchange rate is acceptable, all currencies are convertible. In this way, convertibility can only be meaningful within a certain range of exchange rates. This range normally has very small margins between the rates applied in official transactions and on the market-place (exchange rate unification), as well as a relative and sustainable equilibrium of the balance of payments. In this respect, a single exchange rate is a necessary, but, in itself, not a sufficient condition for full convertibility.

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[1] See Manuel Guitán, "Currency convertibility: concepts and degrees", Proceedings of the IMF-Arab Monetary Fund seminar on currency convertibility, Marrakech, December 1993.

21. The second prerequisite, the proper micro- and macro-policies (sound macroeconomic management) and the effective market environment mean, in particular, sound fiscal and monetary policies that remove the imbalance between aggregate demand and available resources. Adherence to market discipline to reap the benefits of convertibility on resource allocation would be an "extra". These policies safeguard the sustainability of the equilibrium exchange rate.

22. The thesis of sound policies, nevertheless, merits certain qualifications. External developments that affect the balance of payments, particularly in developing countries, such as changes in terms of trade, may render hitherto sustainable exchange rates accompanied by sound policies unsuitable. Hence, countries may find themselves repeatedly displaced from the path they judged to be of sustainable equilibrium. All this means that the external environment affects convertibility, or, in other words, convertibility has a limited degree of internal autonomy.

23. This remark explains in part the conclusion that a fixed exchange rate, meaning the limitation of exchange-rate movements within a narrow margin, is not an indispensable condition for convertibility. Fixity used to be an important element of the pre-1973 historical concept of convertibility and might currently be part and parcel of such programmes at present in particular countries. Argentina is one case where specific conditions, such as a deep-rooted tradition of inflation to be tamed by fixity, justify it, on the condition that the economic structure is diversified enough to protect the country against external shocks. Under the specific circumstances in Argentina, hard-currency policy has effectively brought about disinflation.

24. In countries with lower levels of development and i less imminent danger of inflation, such a pegging may prove to be too costly. They might opt for instead, *inter alia*, monetary contraction under flexible exchange rates. This implies that the central monetary authorities play an active role in the "managed floating" of the exchange rate.

25. Another argument against fixed exchange rates is the recent experience of the European Union's (EU) exchange rate mechanism (ERM). As stipulated in the Maastricht Treaty, monetary integration is the final step in trade and financial integration. Nevertheless, unconditional support for fixed exchange rates in the absence of a long-term strategy can quickly become non-credible in the financial markets.

26. An adequate level of reserves is often confused with the necessity for official resources in regional convertibility zones of developing countries. For the convertibility of individual national currencies, however, a minimum level of international reserves is not a precondition for successful programmes. Unlike commercial banking, there is no internationally accepted official standard of minimum reserves for central banks. The often quoted three-to-one ratio between reserves and monthly imports is just an approximate and non-binding empirical finding which does not necessarily apply to every country. Rather it is sound macroeconomic management and consequently credit-worthiness and access to foreign exchange that determine what are "adequate" reserves.

27. It therefore follows that developing countries with persistent balance-of-payment problems, that are members of cooperation groupings, may opt for the creation of common reserve funds and/or common convertible currencies. With its increased economic power and common

resources, the entire region would have a better chance of consolidating convertibility. Another solution may be to obtain a safeguard from outside, such as in the case of the francs of the Communauté/Coopération financière africaine (CFA), that are guaranteed by the Banque de France.

28. The European Payments Union (EPU, 1950-1957) is an interesting historical case. Even the relatively strong European economies needed the backing of a capital fund contributed by an even stronger country, in the event, the United States, to achieve convertibility. The implication is that multilateral clearing systems require some form of balance-of-payment support in order to forestall the eventuality of weaker economies running out of resources and causing the system unresolvable arrears problems.

29. In contrast to historically successful schemes, debtors within the payments system of the Council for Mutual Economic Assistance (CMEA) were not obliged to settle part of their deficits in dollars or in other convertible currencies. Furthermore, because CMEA stipulated low interest rates for the automatic credits for bilateral trade, the stronger exporting country tried to limit its exports to the weaker exporting country to the level of near-balance. As a consequence, trade levels were determined by the exporting capacities of the weakest countries.

30. The effectiveness of bilateral clearing was further weakened by other economic policy elements which dominated the economic relations among member countries. Due to the rigid planning systems, cost and price structure differed widely among them, and also from the rest of the world. Trade regulators, uncertain about cost and price conditions, could only promote the exchange of essential goods for essential goods, and unimportant items for unimportant items. In this system, prices were nominally given but served accounting purposes only. What really mattered to the governments was to fulfil the compulsory quotas for essential products. The clearing positions lost their original meanings, and the value of transferable roubles varied from country to country and from product to product.

Chapter IV
Scope, implications and uses of convertibility

1. Issues of current- and capital-account convertibility

31. Historically and practically, current-account convertibility has preceded capital-account convertibility and has proved easier to implement. Moreover, current-account transactions have a clear definition in the IMF Articles of Agreement (Article XXX(d)) themselves, while capital transactions are listed only by the Organisation for Economic Cooperation and Development (OECD) and EU. Nevertheless, there has recently been a move towards capital-account convertibility in many countries.

32. Given the current level of global capital-market integration, convertibility is a prerequisite for the mobilization of resources on these markets. The way governments regulate inward/outward securities investments and holdings of foreign exchange (the degree of capital-account liberalization) is an important factor for establishing regional capital markets. Although it may be optional, regional capital-account convertibility of national currencies will make a programme of monetary cooperation and a potential regional capital market very efficient. If capital-account convertibility is introduced within a grouping, it should be accompanied by efficient cooperation schemes among the central banks concerned. A degree of monitoring is all the more necessary in view of the lack of central bodies in participant countries to oversee cross-border clearings and settlements between different commercial banks.

33. Currently, both developed and developing countries share varying degrees of liberalization which are not always connected with the level of development.[4] In OECD, 11 of the 23 member countries, including the United Kingdom, Japan, Canada and Italy have very liberal systems. In contrast, Greece, Portugal, Turkey, Spain and Austria have several restrictions. In the non-OECD group, a liberal approach characterizes not only such relatively advanced territories as Hong Kong and Singapore, but also Panama, Jamaica and Tunisia. On the other hand, there are restrictions in countries such as the Republic of Korea, Morocco, Philippines, Trinidad and Tobago, Chile, Indonesia, Pakistan, Sri Lanka and Nigeria.

34. A common feature of developing countries is the divergence of regulations within the same group like in the Caribbean Community (CARICOM) and the scarcity of intraregional preferences (some exist within CARICOM, the Southern Cone Common Market [MERCOSUR] and the of West African Monetary Union [WAMU]). Some developing countries restrict foreign ownership of securities. These restrictions are general (51 per cent in India, 49 per cent in Indonesia, 25 to 50 per cent in Thailand, 5 to 49 per cent in Cyprus, etc.), although exemptions are sometimes

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[4] For details and a comparison between OECD and developing countries, see Tables 10 and 11 of "The role of regional capital markets in enhancing resource mobilization and in promoting their efficient use" (UNCTAD/ECDC/246), 31 August 1994.

granted. Regional preferences or preferences among developing countries are rare. One of the few cases mentioned is Kuwait where the general limit is 49 per cent, but nationals of the Cooperation Council of the Arab States of the Gulf (GCC) are exempted up to 75 per cent.

35. Capital-account convertibility has both advantages and disadvantages. The advantages include:

- the attraction of foreign investment;
- the accelerated introduction of improved technologies and production methods;
- increased knowledge by foreign investors of a country's market opportunities;
- decrease or even reversal of domestic savings moving abroad, as local savings seek new opportunities; and
- the enlargement of the tax base.

36. The disadvantages include:

- increased exposure to international volatility of capital flows;
- possibility of capital-flow reversals with impacts on exchange rates and monetary management;
- foreign competition for domestic banks, leading to a need to restructure the industry; and
- decreased monetary policy autonomy.

37. Against this background of positive and negative effects, it is only natural to wish to benefit from the former while minimizing the latter. One way is to adopt national policies aimed at controlling inward and outward capital flows or even restricting short-term flows by increasing costs or establishing limits.[5] The crisis of the emerging markets in 1994-1995 has confirmed the usefulness of some of these policies. Another important and useful way to reduce volatility is through regional and subregional cooperation.

38. Although not always indispensable, regional capital-account convertibility of national currencies would facilitate a programme of monetary cooperation and mobilization of intraregional savings and also make it more efficient.

39. The capital-account liberalization programmes of individual developing countries may relax capital controls on intraregional flows in the short run, while leaving global capital-account liberalization as a discretionary measure for individual governments, depending on the strength of their domestic economies and their regional cooperation in the global financial context and their external account situation.

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[5] For examples and details, see "Policy responses in some developing countries to recent increases in capital inflows", in *Trade and Development Report 1994* (UNCTAD/TDR/14), pp.105-106.

2. Micro- and macroeconomic implications

40. Convertibility has both micro- and macroeconomic implications for the domestic economy. On the microeconomic side, it is a means to link a country or region with the prices of the world economy, and to bring resource efficiency into play. The macroeconomic aspect brings about timely adjustments and imposes constraints on inappropriate policies. Convertibility therefore places pressure on countries to avoid bad policy measures, which they might have been inclined to follow had inconvertibility continued.

41. Convertibility as an objective forms a subset of broader macroeconomic goals such as liberalization and openness. The approach to convertibility needs to be sequenced with the fulfilment of preconditions. There is also a need to recognize that reforms are a cumulative and incremental process and that the pace of progress depends on many factors, domestic, regional and international.

42. The success of a convertibility programme hinges on the credibility of the reform process. In this respect, authorities need to share with the market a common set of expectations. This can help to smooth out destabilizing fluctuations which can occur in the absence of complete information and which can jeopardize the move to convertibility.

3. Implications of limited convertibility

43. As to the interaction between convertibility and regional payments arrangements, at a first glance, such arrangements might be viewed as an alternative to the adoption of the difficult policies needed for restoring viability to the balance of payments and external accounts. But a more thorough analysis proves that they are a means to support both regional financial cooperation and global integration. In this sense, regional payments arrangements may be seen as a transition stage towards full convertibility.

44. Such is the thinking which underpins the acceptance of national currencies within a determined region (limited convertibility). As it leads to a fast intraregional liberalization of transactions, limited convertibility is a useful transition for countries that wish to create global convertibility in the long run but cannot do it in the short run. Limited convertibility brings about positive elements, such as learning from consultations with partners, the symmetry of obligations and intensified monetary cooperation. In the short term, the payments systems will function well if market exchange rates are used to determine the central rates.

45. The key to a successful arrangement is to find the method that best facilitates the expansion of regional trade, yet does not lead to the accumulation of arrears. Depending on the economic situation and foreign reserve position of the countries involved, success hinges on various factors: to wit, that all member countries settle their balances in hard currencies, or accept ceilings on automatic credits and gradually reduce their credit lines. An additional help is the introduction of a currency swap scheme which can be effective in reducing arrears and/or extra credit lines.

46. Given the length of the period required for a complete transition from inconvertibility to full convertibility (a period which can last for decades), the room for limited convertibility, particularly within the framework of payments arrangements and settlement mechanisms, is ample. Limited convertibility should not foster the postponement of the necessary economic adjustments in the member countries.

Chapter V
Historical cases of regional convertibility

47. The EPU provides interesting lessons. Founded in 1950 among the Western European members of the Organisation for European Economic Cooperation (OEEC), EPU started as a multilateral clearing-house.

48. The EPU deserves attention because of a particular aspect. While it allowed its member countries to clear their deficits with a combination of credit and hard currencies (or gold), it eventually required them to increase the percentage of the portion paid in hard currencies.[6] In 1949, it assigned each member country a "quota". Small surpluses and deficits (up to 20 per cent of the quota) of clearing balances were totally covered by credits. If deficits exceeded 20 per cent, the percentages of payments required in hard currencies rose progressively; from 20 to 40, 60, 80 and, finally, to 100 per cent of the deficit above the quota had to be settled in dollars or gold. Similarly, if surpluses exceeded the 20 per cent limit, the creditor had to receive 50 per cent of the excess in credits. This gradual and symmetrical approach seems to have worked effectively to harmonize the objectives of trade expansion with the exclusion of unsettled arrears.

49. While the EPU is often referred to as a success, the attempt by Eastern European countries to form their own multilateral clearing arrangement for regional convertibility is generally considered to have failed. Their organization, the CMEA, founded in 1949, ceased to exist in 1991. Its structure reflected the domestic economic conditions and institutions of member states: the dominant role of the state and its consequent monopoly of foreign trade.[7] Instead of having a financing mechanism/channel among central monetary authorities in the service of trade among enterprises of different countries, participant states took control of the production and commercialization process and negotiated state-to-state arrangements with other member countries to determine exports and imports by these sectors on a production-sharing basis.

50. According to the intentions of the creators of the CMEA payments system, the transferable rouble was to be a regionally convertible international currency (clearing unit) among member countries. In theory, clearing surpluses accumulated in one country could be transferred to clear deficits in another country. In reality, however, a system of bilateral clearing arrangements prevailed. Countries with surpluses did not accept the transferable roubles accumulated in trade with a third country as a means of settlement, and the deficits had to be cleared bilaterally. Debtors within CMEA did not have any obligation

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[6] See Robert Triffin, *Europe and the Money Muddle: From Bilateralism to Near Convertibility, 1947-1956*. New Haven, Yale University Press, 1957.

[7] For a description of the CMEA in the context of the socialist economic regime, see chapter 14.5 "An attempt to integration - the Council for Mutual Economic Assistance", in: J. Kornai, *The Socialist System. The Political Economy of Communism*. Oxford, Oxford University Press, 1992.

to settle part of their deficits in dollars or in convertible currencies.

51. The logic of CMEA trade led inevitably to a dead end in regional convertibility. Faced with the transition to a market economy and with the change-over of accounting units into dollars, the commercial banks that attend to the needs of the newly emerging private sectors of ex-members of CMEA have been creating their own cross-border clearing mechanisms without recourse to the central banks.[8]

[8] In February 1993, 10 commercial banks from 5 Central and Eastern European countries (Bulgaria, Czech Republic, Hungary, Poland, Russian Federation) created an ECU-linked, private, non-profit organization under the name of Clearing Bank Association (ABC). Operational since September 1993, it clears trade and other transactions, which arise among intragroup clients in member countries. ABC funding has two main sources: (1) bilateral credit facilities through bank lines among participants; (2) external stand-by credit lines by international institutions, used both as a permanent credit facility (but with a penalty rate for debtors) and as a stand-by facility in case of emergency.

Chapter VI
Recent examples and cases of regional convertibility

52. In the developing world, the efforts towards regional convertibility in the framework of multilateral payments and clearing arrangements (see Annex: Overview of multilateral payments and clearing arrangements among developing countries) have had mixed results. This study highlights the most important lessons of the West African, Asian and Latin American experiences.[9]

53. The most often quoted example of limited currency convertibility is that of West Africa. The concept of limited currency convertibility was elaborated by UNCTAD in 1983, specifically for the Economic Community of West African States (ECOWAS) and its West African Clearing House (WACH). Since the creation of the WACH in 1976, its multilateral clearing zone, within which trade surpluses and deficits have been, in principle, freely convertible, has functioned as a limited convertibility area, with the West African Unit of Account (WAUA) as a regional convertible currency. To attain this goal, member countries tried to make it compulsory to route all eligible transactions through the clearing-house.

54. In West Africa, limited convertibility was proposed with the following features: (i) no exchange and trade restrictions within the grouping; (ii) no restrictions on invisibles; (iii) restrictions on capital transactions permitted; and (iv) convertibility into a defined set of currencies (regional currencies). These conditions could be gradually matched through a process where currencies were fully exchangeable within a certain account but would be used only for a defined range of transactions. This implies that countries could maintain some restrictions on transactions for trade or invisibles, or for capital flows.

55. The attempt was not totally successful, however, because of the low level of intraregional trade and the non-complementary character of exports, and no monetary cooperation. Furthermore, there was a large measure of heterogeneity among members, with the French-speaking members having their common regionally convertible currency (the CFA franc), which has the backing of the Banque de France (for details on the zone, see box 1), while the other countries have had non-convertible national currencies. Between the non-convertible national currencies and the CFA franc is the Nigerian naira, which is widely accepted and is used by the small traders of neighbouring WAMU countries to buy Nigerian industrial goods. Due to diverging levels of convertibility, the demand for various currencies is not uniform. Even after the devaluation of January 1994, the demand for the CFA franc bids above the other currencies, with the overvalued currency having consequences on intratrade. Finally, the ECOWAS region is still trying to find ways to minimize unrecorded trade that has repercussions both in the national budgets and in regional cooperation.

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[9] For more details, refer to "Clearing and payments arrangements among developing countries: recent developments, long-term policy considerations" (UNCTAD/ECDC/238), 4 February 1994.

Box 1
The CFA franc zone

The CFA franc zone comprises a group of countries in West and Central Africa. The functioning of this CFA zone is based on the following elements: (i) full convertibility into French francs at a fixed parity; (ii) the French Treasury guarantees convertibility through the establishment of "operations accounts" for each African central bank; (iii) free capital movements throughout the region; (iv) pooling of most foreign exchange reserves at the French Treasury, and (v) establishment of common trade and financial policy vis-à-vis the rest of the world.

The CFA franc was linked to the French franc at a fixed rate of 50 to 1 from 1948 till January 1994. In January 1994, the governments of the CFA franc zone were compelled to change this parity to 100 CFA francs for 1 French franc. At the same time, the Banque de France offered the same guarantee for the new exchange rate as the one which had been in place for the previous arrangement.

The economic reasons for the devaluation of January 1994 as presented by the IMF and the Banque de France, were twofold. First, the intraregional demand for convertible CFA francs had been a permanent pressure on the CFA franc zone for revaluation against other ECOWAS domestic currencies, although the local commodity producers of the zone, plagued by low export prices and loss of competitiveness, would have required the contrary. Second, after the mid-1980s, the French franc, to which the CFA franc is pegged, started to strengthen against the US dollar, leading the zone to the same level of overvaluation. While devaluation offers relief for the exporters of the zone, it does not lift the pressure on the CFA franc for gradual revaluation against other currencies of the ECOWAS region, originated in the differing degrees of convertibility of local currencies.

56. The West African case raises the issue of the **sustainability** of the payments systems. While the WACH has not been totally successful in this respect, other schemes such as the Asian Clearing Union (ACU) and the Latin American Integration Association's (LAIA) payments system have made more progress.

57. The ACU has proven to be the most smoothly functioning and the best managed clearing arrangement of developing countries. It has been able to avoid the accumulation of arrears during its entire existence. It also has promoted the use of participants' currencies in current transactions including the compulsory routing of all intragrouping trade (except between India and Nepal), which led to significant savings in fees paid for internationally traded currencies. In 1989, the ACU launched its Swap Arrangement Facility, a mechanism for avoiding the shortage of currencies in regional trade deficit countries and the consequent bilateralization of the multilateral clearing relations (for details, see box 2).

58. ACU transactions are recorded in Asian Monetary Units (AMU) that have the same value as SDRs. ACU has taken steps towards the parallel regional convertibility of its participants' national currencies and of AMU. With the swap mechanism, though the volume of transactions is low for the moment, the regional convertibility of national currencies is improving and the smooth functioning of the clearing-house is increasing the regional acceptance of AMU. Its uncompromised stance on arrears -- balances should be paid at the end of the settlement period in full and

Box 2
The ACU Swap Arrangement

According to the rules of the ACU Currency Swap Arrangement, any participating central bank with an intratrade deficit at the end of a settlement period may avail of the facility in the clearing centre. The maximum entitlement is 20 per cent of the average gross payments of the applying central bank at the end of settlement periods during the three previous calendar years, but no more than its overall deficit at the end of the current settlement period. Interest rates on drawings against the swap facility are based on the London interbank mean rate (LIMEAN). Drawings under the Currency Swap Arrangement have the same deadline as the length of the settlement period (two months). The same central bank cannot avail itself of the facility in two consecutive periods. The first country to use the ACU Currency Swap Arrangement was Bangladesh, which drew AMU 21 million in September 1989. Total drawings against the facility amounted to AMU 178 million by the end of 1993, the most active users being India and Bangladesh, followed by Pakistan (see table).

The use of the ACU Currency Swap Arrangement, September 1989 to December 1993

Date	Member country	Amount drawn in thousand AMU
September 1989	Bangladesh	21,232
May 1990	Bangladesh	23,086
November 1990	India	30,000
January 1991	Pakistan	2,113
June 1991	India	7,100
April 1992	India	23,300
December 1992	India	63,098
June 1993	Pakistan	3,990
October 1993	Pakistan	3,807
September 1989 through December 1993	all member countries	177,726

Source: Asian Clearing Union Annual Reports 1989-1993.

in hard currencies -- has enabled ACU to launch new initiatives, such as making travel costs eligible for channelling through the clearing-house and eventually extending current membership. The ACU shows that requiring a complete settlement in hard currencies, although costly, can be a safeguard against future problems.

59. In LAIA, the multilateral payments system was set up in 1965 and has been constantly modernized since (for details, see box 3). The aim of the clearing arrangements has been to enhance the regional convertibility of trade credits and debits and thereby to facilitate trade flows.

60. The volume of transactions channelled through the system has increased in two phases, between 1966 and 1981 and between 1986 and 1992. In the first phase, the volume of transactions increased from US$ 100 million to 9.3 billion. After a drop to around US$ 6.5 billion by the

Box 3
The LAIA payments arrangement

The "Reciprocal Payments and Credits Agreement" (Mexico Agreement) was established under the auspices of LAIA's predecessor, the Latin American Free Trade Area (LAFTA), in 1965. It was replaced, in 1982, by a new agreement, under the same name, with the particiption of the central banks of Argentina, Bolivia, Brazil, Colombia, Chile, Ecuador, Mexico, Paraguay, Peru, Uruguay, Venezuela and Dominican Republic. The new Agreement consists of several components, including:

a. the **Multilateral Payments Clearing Mechanism**, based on reciprocal credit lines, and a four-month multilateral clearing period:

Operating procedures: intraregional payments are processed and cleared at four-month periods. At the end of each period (clearing period), only deficits or surpluses of the overall balance of the central bank of each country, with respect to the others, are transferred or received.
Eligible transactions: international payments derived from direct transactions among residents of the countries of the region and cases involving trade financing through authorized commercial banks of third countries (triangular trade) through instrument discounting. (In 1993, the transactions through the triangular trade scheme amounted to US$ 68.5 million, Uruguay acting as intermediary and the transactions originating from Argentina or Brazil).
Channelling of intraregional payments through the Agreement: in all cases voluntary.
Instruments accepted: payment orders, letters of credit, documentary credits, letters endorsed by banks, nominal drafts, promissory notes derived from commercial transactions.
Payments mechanisms: reciprocal credit lines, multilateral use of credit line margins, instrument discount mechanism (since 1990), providing funding for exporters with the guarantee of the LAIA payments arrangement. Instrument discounting is incorporated into the internal regulations of selected member countries but is not applied by other members. (The estimated amount of transactions through this mechanism amounted to US$ 1.1 billion in 1993. The major sources of financing were Uruguay and Chile and the major recipients were Argentina, Brazil and Peru).
Agent and common correspondent bank: the Central Reserve Bank of Peru and the Federal Reserve Bank of New York through which debit and credit balances are settled.

b. the **System of Guarantees** concerned with the convertibiity of national currencies to US dollars, the transerability of payments and reimbursement aand payment of operations; and

c. the two-tier **Automatic Payments Programme**:

The first tier of this programme was established to guarantee transitory financing in the event of lack of liquidity arising from force majeure, with respect to any member central bank, thus preventing them from meeting their debts at the multilateral clearing. The second tier supplies corrective measures, including the extension of the settlement period for part of the negative clearing balance, to attend to these unusual situations.

mid-1980s, the volume of transactions increased again to reach a record of US$ 13.8 billion in 1992, followed by a slight decrease in 1993, to US$ 13.2 billion (see Table 1).

Table 1
LAIA payments system: intragroup imports and level of transactions channelled and cleared (US$ milion)

Year	Intragroup imports	Total transactions channelled though the system	Net settlement in foreign exchange	Ratios in percentages	
	(1)	(2)	(3)	(4)= (2/1)	(5)= (3/2)
1986	7,674	6,673	1,066	87	16
1987	8,496	7,492	1,269	88	17
1988	9,914	8,753	1,458	88	17
1989	11,147	10,137	2,513	91	25
1990	12,381	10,020	3,469	81	35
1991	15,620	11,610	2,866	74	25
1992	19,960	13,772	3,845	69	28
1993	23,600	13,176	3,824	56	29

Source: LAIA

61. In the LAIA region, intra-group trade has grown faster than total trade[10] or transactions through the system. Because of the latter, the ratio of channelling through the payments mechanism to intra-imports decreased from 91 per cent in 1989 to 56 per cent in 1993. While the growth of transactions has been a welcome phenomenon, two developments have threatened the smooth functioning of the system. One was an increase in the share of net settlement in foreign exchange at the turn of the 1990s (it increased from 17 per cent in 1988 to 35 per cent in 1990). Thanks to new mechanisms including an instrument-discounting mechanism (1990) and the authorization to channel payments originating in triangular trade (1992), the share of net settlement in foreign exchange dropped again under the 30 per cent threshold at the beginning of the 1990s.

62. Another problem the LAIA system had was an increase of intragrouping debts up to the level of US$ 5 billion at the end of the 1980s. To address this problem, the LAIA Reciprocal Payments and Credit Agreement was amended in 1991 with a two-tier Automatic Payments Programme for the transitory financing of balances of multilateral compensation (see box 3). Thanks to the Automatic Payments Programme, the stock of intragrouping debts has recently been significantly reduced (from a peak of US$ 5 billion to 700 million), and from 1991, there have been no delays in payments.

[10] The share of intratrade in total trade increased from 12.1 per cent in 1990 to 16.7 per cent in 1992. See *UNCTAD Handbook of International Trade and Development Statistics 1993* (TD/STAT.21).

63. The existence and use of regional schemes raises an additional issue rarely covered by individual countries' efforts to global convertibility. While global convertibility is a means of integration into the world economy, limited convertibility is a means for **intraregional monetary and financial coordination**. The importance of the harmonization of economic policies among the participating countries is highlighted by the observation that unless monetary policies are harmonized, and the degree of convertibility becomes similar among the member countries, the attempt towards regional convertibility seems to be doomed to fail. In this respect, group pressure on slowly advancing countries may be a key element of a convertibility zone.

Chapter VII
Recent experience with the convertibility of national currencies: Argentina and India

64. It might seem that the recent move of several developing countries towards global convertibility collides with the inclination of others towards limited convertibility arrangements, particularly in the form of regional payments arrangements. As global convertibility implies the invoicing of exports in hard currency (either in the "hardened" currency of the developing country in question or with the obligation of invoicing in "the" hard currencies of developed countries), it appears to challenge the existence and usefulness of participation in multilateral payments and clearing arrangements.

65. However, payments and clearing arrangements still afford at least four advantages: (1) Due to deferred payments till the end of the settlement period and even then only the multilateral balances, clearing and payments arrangements may remain attractive for countries with plans for global convertibility. (2) If coupled with credit lines and swap arrangements, these arrangements serve an important credit-access function. (3) Since monetary harmonization is essential to limited convertibility, payments and clearing arrangements serve as a transitory phase towards full global convertibility. (4) Finally, while in themselves, the clearing and payments arrangements are not the only forums for monetary cooperation, they have in the past served to enhance monetary cooperation among their participants.

66. In Latin America, the **Argentinian peso**, as described in Law 23.928 of March 1991, has been freely convertible to the key currency (currently the US dollar) and has therefore been globally convertible since 1991. The most important safeguard of this law is the obligation of the Government to back 100 per cent of the monetary base by gold, hard currencies or assets that are convertible to hard currencies.

67. It is almost certain that the introduction of the *global* convertibility of the peso has a profound effect on the *region's economy* as a whole, as the peso is freely convertible while the currencies of neighbouring trading partners are not. Until the beginning of 1995, the Argentinian authorities have managed to keep the fixed exchange rate and the credibility of the peso against the backdrop of difficult international situations, such as the crisis of emerging markets at the beginning of 1995. Nevertheless, the peso has manifested signs of overvaluation and pressures towards devaluation in real terms. Producers in other LAIA members have a strong incentive to export to Argentina in order to obtain a currency which is freely convertible to dollars. Consequently, there has been a deterioration in Argentina's trade balance (see table 2), and the circulation of the peso in neighbouring countries has increased.

68. It is important that the monetary authorities of the region contribute to maintaining the value and credibility of the peso, which is likely to be the currency of trade in the region at least in the short and medium run. In the long run, other countries of the LAIA region may try to approach to a level of convertibility comparable with that of the peso. The introduction of the real in July 1994 by Brazil as an attempt

Table 2
Argentina's trade balance in goods
(US$ million)

	1990	1991	1992	1993	1994*
Exports f.o.b.	12,354	11,972	12,235	13,090	15,200
Imports f.o.b.	3,726	7,400	13,685	15,545	19,425
Trade balance	+8,628	+4,572	-1,450	-2,455	-4,225

Source: ECLAC, *Economic Survey of Latin America and the Caribbean 1992* (LC/G-1774-P) and *Preliminary Overview of the Latin American and Caribbean Economy 1994* (LC/G.1846).

* Preliminary estimates.

to curb inflation and to improve convertibility might help to solve the problem of diverging levels of convertibility and trade imbalances.

69. As far as the Asian Clearing Union is concerned, most of the member countries have opted for increasing the convertibility of their national currencies. The most far-reaching reforms of the exchange-rate system was adopted by **India** (the Liberalized Exchange Rate Management System [LERMS]) in 1993. The surrender requirement of exporters has been reduced from 100 to 40 per cent. All external transactions, including those of the Government have been switched to the market exchange rate. Import restrictions have been relaxed. Access to foreign exchange for business travel has been liberalized. In order to avoid external imbalances, the Indian rupee was devalued by 20 per cent. In March 1993, the Indian Rupee was declared to be fully convertible on trade transactions by the Federal Reserve Bank of India and a single market-determined exchange rate was introduced for it. (These measures did not necessarily apply to capital-account transactions.)

70. The most important problem of the LERMS arose from the obligation of Indian exporters to invoice in US dollars. This measure, together with the relaxation of compulsory routing of trade through the ACU, meant that the original ACU mechanism could no longer save hard currency in intratrade. Only the advantages of deferred payment remained in place.

71. One possible solution to such problems may be a "dual currency" system that accommodates the different of national currencies. Another solution being used is the move of other member counties towards national convertibility which eliminates this dualism. In the latter case, there are no serious problems created by the use of a single market-determined exchange rate, as in India after March 1993.

72. It is desirable that the mechanism that member countries apply to address the problems arising from the different pace and methods of national moves towards convertibility continue to quote a single exchange rate for intragroup transactions and apply domestic measures by

individual member countries.[11] An AMU/ACU market rate would eliminate this problem. It is equally important that countries wishing to maintain the benefits of the payments system move towards global convertibility while continuing to route their transactions through the clearing-house.

73. From a longer perspective, the improving global convertibility of regional currencies would resolve most of the above-mentioned problems with exchange rates.

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[11] Indian exporters did not wish to export goods at the official AMU rate when they could apply a more favourable market rate for dollars. This is why in January-February 1993, India routed 75 per cent less exports through the ACU than in the same period in 1992. (Imports routed though the arrangement decreased only by 6 per cent because imports at the official exchange rate proved to be less expensive than at the United States dollar market rate). An arrangement to equal the differences between the two rates (for example, export premiums) is a domestic matter, although the preferable solution is the application of the market rate in all trade transactions, including the ones channelled through the clearing-house.

Annex

Overview of multilateral payments and clearing arrangements among developing countries

Name and membership	Operations started	Settlement period (months)	Unit of account	State of transactions	Additional mechanism
ACU (Bangladesh, India, Islamic Republic of Iran, Myanmar, Nepal, Pakistan, Sri Lanka)	1975	2	AMU=SDR	Most regional transactions channelled and cleared; no arrears since 1975.	Swap arrangement since 1989.
CACH-CPS (Costa Rica, El Salvador, Guatemala, Honduras, Nicaragua)	1990, predecessor (CACH) operated from 1961 to 1989	1	Central American peso=US$	Suspended activities in July 1992.	
CHCAS (Burundi, Cameroon, Central African Republic, Chad, Congo, Equatorial Guinea, Gabon, Rwanda, Sao Tome-Principe, Zaire)	1989, in replacement of CAfCH, operational from 1982 to 1988	1	CAUA=SDR	1 per cent of regional trade channelled; arrears problems.	
CMCF (Antigua-Barbuda, Barbados, Belize, Dominica, Grenada, Guyana, Jamaica, Montserrat, St. Kitts-Nevis, St. Lucia, St. Vincent-Grenadines, Trinidad-Tobago)	1977	6	US$	Due to arrears problem, suspended operations in 1983.	CARICOM Traveller Cheques, operational from 1980 to 1993.
LAIA Reciprocal Payments and Credits Agreement (Argentina, Bolivia, Brazil, Colombia, Chile, Dominican Republic, Ecuador, Mexico, Paraguay, Peru, Uruguay, Venezuela)	1966	4	US$	Most regional transactions channelled and cleared; intra-debt has dropped since 1991.	Automatic Payments Programme since 1991.
PTA Clearing-House (Angola, Burundi, Comoros, Djibouti, Ethiopia, Kenya, Lesotho, Madagascar, Malawi, Mauritius, Mozambique, Namibia, Rwanda, Seychelles, Somalia, Sudan, Swaziland, United Republic of Tanzania, Uganda, Zambia, Zimbabwe)	1984	2	UAPTA=SDR	Less than half of regional trade channelled; no arrears since 1984.	UAPTA Travellers Cheques since 1988.
WACH (Benin, Burkina Faso, Cape Verde, Côte d'Ivoire, Gambia, Ghana, Guinea, Guinea-Bissau, Liberia, Mali, Mauritania, Niger, Nigeria, Senegal, Sierra Leone, Togo)	1975	1	WAUA=SDR	1 per cent of regional trade channelled; arrears problems.	